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Subsidy and Countervailing Duty Issues in the Context of North American Economic Integration

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Chapter 5

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Introduction

The role of subsidies in international trade is a hotly contested issue, whose resolution has escaped concerted efforts at multilateral as well as bilateral levels. Although the Tokyo Round trade negotiations made some headway in dealing with the problem, they failed to resolve it. Efforts to establish acceptable subsidy codes at regional and bilateral levels have not fared much better. The issue was a key component, for example, of the Canada-USA free trade negotiations, but there, too, resolution was not attainable. The problem arises partly from different perceptions of the role of the state in the promotion of economic activity. Europeans tend to be more interventionist, for example, than Americans, although Americans see themselves as less interventionist than they really are. Developing countries, for their part, justify intervention on infant-industry grounds and remind the USA and other advanced nations of the importance of such policies in their own industrial histories.

Indeed, one of the difficulties in dealing with subsidies is to define and then distinguish between "good" and "bad" subsidies. A subsidy which would, in a perfect world, be labelled prejudicial, may in a world of imperfect markets and imperfect policies merely serve to offset existing distortions. Defining and identifying beneficial subsidies and separating them from their distorting and anti-competitive counterparts is, however, a very difficult task.

Common logic suggests that subsidies which have no effect on other countries do not warrant intervention on the part of the international community, no matter how distorting they are. The reason is that the cost of such distortions falls entirely on the subsidizing country. Under U.S. law, however, the executive branch is obliged to retaliate against subsidies of this type. This paradox may be explained in part by the fact that policymakers in the USA do not always fully understand the problem they are supposed to solve and do not always carefully weigh the interests they are serving in seeking solutions to the problem. Not infrequently, the interests of particular producers are treated as if they were identical with those of the nation.

One of the major disagreements between the United States and other countries pertains to the role of subsidies in economic policy. Americans believe that their country's markets are relatively free of government intervention. Europeans and others assert that the difference is mainly one of style and that much of U.S. support to industry is hidden in the defense budget and behind national security arguments.

Be that as it may, the primary U.S. goal in international negotiations at various levels has been to force other countries to relinquish subsidies as a policy tool. The negotiating objective of America's trading partners, on the other hand, has been to curb U.S. anti-subsidy policies. These differences in objectives have contributed to repeated stalemates at the negotiating table.

One point of contention has been to define and identify national subsidies that are harmful to the interests of other countries and to separate them from those that are not. Another has been to design constructive countermeasures to harmful subsidies. U.S. policy has been very unclear on both fronts. At times the primary U.S. goal has appeared to be one of merely "leveling the playing field," in which case a countervailing duty should be just large enough to offset the adverse effects of foreign subsidies. At other times, the principal thrust of U.S. policy has appeared to be punitive, that is, to punish trading partners for using subsidies, regardless of their external effects. At still other times, the objective appears to have been preservation of the competitive advantage of particular U.S. industries.

When the United States and Canada began their trade talks, the hope was widespread that new ground would be broken on the issue of subsidies and that the bilateral agreement would serve as a guide and example for Uruguay Round negotiators. Those hopes were not realized, as the problem turned out to be no more amenable to resolution between two close and largely similar neighbours, than in the context of multilateral talks. In the

Canada-USA agreement, the subsidies issue was ultimately reserved for follow-up negotiations which to date have made little progress. With the prospective addition of Mexico in a North American Free Trade Area, the importance of dealing with these issues takes on additional urgency.

The issue is extraordinarily complex, analytically, empirically, and in relation to the formulation and implementation of policy. The discussion that follows addresses some, but by no means all, of the salient issues in the context of the North-American free trade negotiations. There is no reason to suppose that the trilateral negotiations now in progress will be more successful in resolving the issue of subsidies and their antidotes than the GATT and the USA-Canada bilateral.

The next section provides an overview of the salient issues. The paper then considers some general effects of domestic subsidies on a country's trading partners. The penultimate section examines alternative strategies of response to foreign subsidies. It is followed by concluding comments.

An Overview of CVD-Subsidy Issues

The United States has been by far the most frequent user of CVDs. As a result of various grandfathering provisions in U.S. trade legislation and recognized by the GATT, the U. S. has not been bound by requirements that restrict CVDs to cases of material injury.

Countervailing duty investigations begin with petitions to the Commerce Department and International Trade Commission (ITC) by a domestic party alleging that goods entering the U.S. market from abroad are the beneficiaries of foreign subsidies.[1] The responsibility of the Commerce Department is to determine if the imports in question are in fact benefitting from a subsidy, while the ITC tends to focus on issues of injury. If both Commerce and the ITC make an initial positive ruling, the importer in question must post bond guaranteeing payment of the CVD if the ruling is upheld.[2] This bonding procedure, or "suspension of liquidation," is important in that it brings the exporting firm directly into the investigation.

Once the initial rulings are issued, there follows a period of up to four months of suspension of liquidation before the final determination is issued.

1 Finger, J. Michael, and Tracy Murray, "Policing Unfair Imports: The United States Example," *Journal of World Trade*, Vol. 24, No. 4, August 1990, provide a detailed description of the entire CVD procedure in the USA.

2 Even if the initial ruling by Commerce is negative, the investigation continues, but no bond need be posted. See Finger and Murray (1990), p. 40.

The importer and the injured domestic industry may at any time during this period reach a negotiated settlement which either eliminates the subsidy or limits the extent of market disruption by means of a voluntary export restraint or a price undertaking.[3] Negotiated settlements void producer petitions and thereby close the case. In the absence of negotiated settlements, a final ruling of subsidy and injury is required and, if positive, is followed by imposition of a countervailing duty.

Current CVD policies and procedures create strong incentives for "out-of-court" settlements and thereby encourage collusion and legitimize cartelization. The domestic firm has an incentive to reach a collusive agreement, because it cannot be sure that the initial positive ruling on subsidization with injury will not be reversed in the final stage. In the presence of this type of uncertainty, price undertakings or VERs represent an attractive alternative to the risk-averse domestic petitioner.

Although a negotiated settlement eliminates any possibility of a negative final ruling of subsidy or injury, it nevertheless offers advantages to the foreign exporter, particularly if it spawns VERs that facilitate cartelization of relevant markets. It brings immediate lifting of the suspension of liquidation and thereby eliminates the disruptive effects of prolonged uncertainty. There is, of course, less incentive for the exporter to negotiate a settlement to eliminate the subsidy if it does not leave room for cartelization. Such an agreement not only eliminates the benefit of subsidized production destined for the U.S. market, but may erode political support at home for production subsidies of exports aimed at third markets.

Development of a new international code on subsidies was one of the major issues on the agenda of the Tokyo Round of trade negotiations in the late 1970s. Although a code was negotiated, it fell far short of most expectations,[4] in part because fundamental differences among countries precluded a strong and comprehensive agreement. The negotiations broke

3 A price undertaking is an agreement to establish a minimum price floor for exports to the domestic market. As Hufbauer notes, "the worst punishment coming out of a CVD proceeding is that the offender is told to raise his prices--hardly an effective deterrent." Hufbauer, C. Gary, "Subsidies," in Jeffrey J. Schott, ed., *Completing the Uruguay Round*, Washington, DC: Institute for International Economics, September 1990, p. 106.

4 See, for example, Stern, R., and B. Hochman, "The Codes Approach," in J. Michael Finger, and A. Olechowski, eds., *The Uruguay Round: A Handbook for the Multilateral Trade Negotiations*, Washington, DC: The World Bank, 1987; and Tarullo, D.K., "The MTN Subsidies Code: Agreement Without Consensus," in S.J. Rubin, and G.C. Hufbauer, eds., *Emerging Standards of International Trade and Investment*, Totowa, IA: Rowman and Allanheld, 1983.

little new ground on the central question of the definition of subsidies requiring international surveillance and control. The hope, moreover, that the gradual development of case law would provide practical answers to this question has so far not been realized.

The experience of the Tokyo Round negotiations on a subsidies code demonstrates the magnitude of the philosophical gaps that separate countries on this issue. While many governments openly espouse and pursue interventionist industrial policies and developmental strategies, the official United States position, not always reflected in practice and policy, is opposed to intervention.

Subsidies and the USA-Canada Bilateral

The bilateral negotiations on the free trade area between the United States and Canada addressed the issue, but failed to reach a resolution, in spite of hopes on both sides that establishment of a comprehensive code might serve as a model for the Uruguay Round. Although Canada did succeed in placing some restraints on U.S. process protectionism, fundamental disagreements in a number of areas of principle kept the two nations from reaching a comprehensive agreement. In the matter of process, the USA agreed to prior consultation on prospective changes in countervailing duty law and to binding arbitration in bilateral CVD disputes, but little headway was made on the issue of subsidy discipline itself.[5] This issue is likely to be at the core of the upcoming negotiations with Mexico, where it will be no more amenable to resolution than before, unless the negotiating parties can reconcile some of their philosophical differences. The USA, for its part, will have to clarify the objectives of policy in this respect. Many past CVD actions have done more, others less, than achieve a "level playing field." Policy has encouraged rather than rectified inefficient resource utilization; it has contributed to the cartelization of markets; and it has, by allowing VER settlements, strengthened the long-run competitiveness of foreign producers.

Among the unresolved and outstanding problems between the USA and Canada are agricultural subsidies, which are important to both countries; the treatment of subsidies at sub-federal levels; and the general role of domestic subsidies, given Canada's historical reliance on intervention of this type.

5 See Schott, Jeffrey J., and Murray G. Smith, eds., *The Canada-United States Free Trade Agreement: The Global Impact*, Washington, DC: Washington Institute for International Economics, 1988, p. 44.

Fears that curtailment of subsidy policies would weaken competitiveness in relation to third countries added to Canada's reluctance to fashion a comprehensive, albeit bilateral, accord. In the end, the two countries agreed to disagree and to attempt to resolve their disagreements in ongoing negotiations within the bilateral Working Group on Subsidies.

Substantive Issues in the Treatment of Subsidies

From the standpoint of traditional national economic efficiency considerations, concerns about foreign subsidies make little sense. Foreign restrictions on international trade have been a legitimate area of concern because of their adverse effects on the importing country's terms of trade. Foreign subsidies, on the other hand, improve the importing country's terms of trade. While such subsidies may not be in the aggregate economic interests of the country granting them, trade theory suggests that the importing country should take full advantage of the reduced cost of imports.

An important exception, long recognized in the literature on anti-dumping, is the possibility that predatory subsidies could be used to drive competitors out of business, leaving the market ripe for subsequent monopoly pricing. The conditions necessary for successful predation are quite stringent, however, so that the need for international concern over this possibility is likely to be quite limited.[6] More recently, analytical work in the context of strategic trade theory has shown that foreign subsidies could under certain oligopolistic market structures generate net losses for the importing country. Here too, however, research suggests that the policy relevance of such concerns is quite limited.[7] Furthermore, in both the predatory pricing and strategic trade policy cases, the most effective response by the importing country tends to be case-specific rather than a broad policy regime of countervailing duties against all subsidies.

Market intervention through subsidies has been justified in a variety of ways, many of which cannot sustain close analytical scrutiny. Production and export subsidies are economically justifiable if their purpose is to

6 See Yeager, Leland B., and David G. Tuerck, *Trade Policy and the Price System*, Scranton, PA: International, 1966 and Jackson, J.H., "Perspectives on Countervailing Duties," *Law and Policy in International Business*, Vol. 21, No. 4, 1990.

7 See, for example, Baldwin, Robert T., "Strategic Trade Policy," JEL (forthcoming); and Haberler, Gottfried, "Strategic Trade Policy and the New International Economics: A Critical Analysis," in R.W. Jones, and A.O. Krueger, eds., *The Political Economy of International Trade*, Cambridge, MA: Basil-Blackwell, 1989.

counteract market imperfections and distortions. A widely recognized category of "imperfections" justifying intervention arises in the context of externalities that will not or cannot be internalized by private agents. In these and similar cases, subsidies are an economically efficient--albeit fiscally costly--form of intervention to minimize the "deadweight" costs of distortions. Subsidies of this type belong to the class of so-called benign subsidies and are not countervailable in principle.

However, it is often not easy in practice to distinguish between benign and distorting subsidies and, in case of either, to determine the precise nature of the distortions. Subsidies are easily and frequently abused. Rent-seeking through the political system by well-organized interest groups can lead to subsidies which neither offset distortions nor create beneficial externalities.

Hufbauer (1990) has suggested that subsidies were probably overused prior to the late 1980s, but that their use and their impact on international trade have recently declined in many countries. Reasons given by Hufbauer include budget constraints brought on by competition from other interest groups (e.g. health, education, the elderly, and environmental interests), growing public scepticism about the costs and benefits of industrial policies, and the international debt crisis.

Even where justification for countervailing duties can be shown to exist in principle, determining the size of the duty is fraught with difficulties. It is rarely the case that the optimal size of the duty matches the size of the nominal subsidy. The former is very typically smaller than the latter, and may in some non-trivial cases be negative.[8] Determining the correct size of a countervailing duty becomes especially troublesome in the context of subsidies, in which the distorting, and hence countervailable, effects of various subsidies may be interdependent, but offsetting in some instances and reinforcing in others. In such an environment, countervailing duties may not only increase the overall degree of distortions in world markets, but worsen the competitive position of the very domestic producers they are designed to protect.

In most cases of countervailing duties, the required size of the duty is a function of the stated objective; it will vary depending on whether that objective is to level the playing field, punish the subsidizing country, or collect revenue. There is scant evidence that U.S. policymakers are clear

8 See Gaisford, D. James, and Donald L. McLachlan, "Domestic Subsidies and Countervail: The Treacherous Ground of the Level Playing Field," *Journal of World Trade*, Vol. 24, No. 4, August 1990.

on these issues, in spite of the official rhetoric stressing the level-playing-field objective.[9]

Conflicting Policy Objectives

Not only do U.S. policy objectives on this issue appear muddled and driven by interest-group pressures and preferences rather than clearly articulated considerations of the national interest, but they differ substantially from those of other countries. In spite of the recent increase around the world in resistance to subsidies tied to industrial or development policies, countries that have used them do not want to see their policy freedoms restricted. The United States, for its part, wishes to maintain its right to the unrestrained use of countervailing duties.

The political foundation of the U.S. position has several pillars. There is the aforementioned equity and fairness argument that the playing field of international trade has become too tilted by government interventions of all sorts and that its level needs to be restored. Implicit in this position is the belief that U.S. subsidies are significantly lower and less distorting than those abroad. This is an argument that is widely disputed among America's trading partners.[10]

American policymakers and the industry groups that seek CVD protection believe that subsidies give foreign exporting firms unfair advantages. Countervailing duties are seen as a means of nullifying these advantages--at least as far as competition in the U.S. market is concerned. In many instances, the threat of a CVD action may be more valuable from the perspective of a petitioning firm or industry than its realization. This is the case whenever foreign producers targetted by the action agree to settle "out-of-court" and whenever such settlements increase the monopoly elements governing production and/or distribution. It is important to note

9 For useful reviews of U.S. policy in this area, see Finger, J. Michael, "Antidumping and Antisubsidy Measures," in Finger and Olechowski, *The Uruguay Round*; Finger, and Murray (1990); Hufbauer, G.C., and J. Shelton Erb, *Subsidies in International Trade*, IIE, 1984 and Jackson (1990).

10 In a recent study, for example, Gaisford and McLachlan (1990) compare "standardized" U.S. and Canadian subsidy rates at the federal level and find that the USA had higher rates in a large majority of the cases examined. They find further that "high (low) US industry subsidy rates [tended] to be paired with high (low) Canadian subsidy rates" (p. 64).

that commonly such negotiated settlements are advantageous to both domestic and foreign producers at the expense of consumers.

The possibility of such outcomes creates a non-trivial moral-hazard problem arising from incentives to file petitions which may be intrinsically frivolous, but which may nevertheless induce foreign producers to settle. It was, indeed, the desire to protect its producers from this kind of harassment that animated Canada's interest in developing procedures for prior notification, bilateral consultation, and bilateral dispute settlement.

For the countervailing as well as the subsidizing nation, therefore, the present system creates significant opportunities for abuse. Interest groups in the former can turn countervailing duties into protectionist barriers against imports,[11] while the policy process itself may encourage producers in both to attempt to cartelize the domestic market by means of VERs.

Regional vs. Multilateral Approaches

The uncertain future of many subsidy-CVD issues at the multilateral level of the GATT increases the importance of regional efforts to find workable solutions. This certainly includes the forthcoming talks among the three North American nations.[12] The significance of this effort is enhanced by the fact that a number of the most controversial U.S. CVD cases have involved Canada and Mexico. Examples include regional tire subsidies, alleged subsidized stumpage for timber in Canada, pricing of natural gas by Pemex, and the ceramic tile case of alleged subsidized official finance involving Mexico.[13] In the case of Mexico, moreover, questions regarding the treatment of infant-industry subsidies and of other interventions related

11 For recent summaries of the growing literature on the political economy of trade policy and the role of interest groups, see Baldwin, R.E., *The Political Economy of U.S. Import Policy*, (1985a); and Baldwin, R.E., "Trade Policies in Developed Countries," (1985b); Hillman, Arye L., *The Political Economy of Protection*, Harwood Academic Publishers, 1989; and Odell, John S., and Thomas D. Willett, *International Trade Policies*, Ann Arbor, MI: The University of Michigan Press, 1990.

12 See the useful summary of Uruguay Round negotiations on subsidy issues in Hufbauer (1990).

13 For further discussion of these and other cases, see Hufbauer and Erb (1984); Finger and Murray (1990); and Weintraub, S., *A Marriage of Convenience*, New York, NY: Oxford University Press, 1990. See also Siac, R.C., "The Use and Abuse of Unfair Trade Remedy Laws: The Mexican-U.S. Experience," Toronto: Centre for International Studies, January 1991.

to development policies, all issues which have been avoided by the GATT in the past, will complicate negotiations.

Bilateral and regional aspects of this issue are especially important in view of U.S. policy of applying MFN code treatment only on a conditional basis. Specifically, the USA has been willing to apply the material injury test for CVD actions only to countries which formally declare their intention to reduce subsidies. It is unclear to what extent this show of goodwill applies to all subsidies or only to the distorting kind. It means, however, that the USA has in effect adopted a country-specific approach to the issue of subsidies.

The Canadian-U.S. free trade negotiators were not able to reach agreement on a subsidies code,[14] in part because some believed that the problem was not amenable to bilateral resolution wherever competition from third parties was involved. Although further efforts are being expended to find bilateral solutions, this issue lies at the heart of the conflict between bilateral and multilateral approaches to trade liberalization and conflict resolution.[15]

This issue will be no less important in the upcoming North American negotiations. Agreements on subsidy-CVD issues might be difficult to achieve within a North American free trade area. A comprehensive agreement could, on the other hand, serve as a model for negotiation at the multilateral level. The possibility that aspects of the USA-Canada agreement might serve as role models to the world at large was indeed one of the great hopes of the talks at their beginning.

Points of Contention

A number of key analytical issues have arisen in the context of disputes over subsidies and CVD policies.[16] One is the need to develop better criteria for identifying subsidies that are most troublesome or distortive of

14 See Schott and Smith (1988) and Wonnacott, Paul, *The United States and Canada: The Quest for Free Trade*, Washington, DC: Institute for International Economics, 1985.

15 For recent treatments of these issues see Arndt, S.W., and Thomas D. Willett, "EC 1992 From a North American Perspective," *Economic Journal*, Vol. 101, No. 409, November 1991; and Schott (1989) and the references cited there.

16 For more detailed discussions, see Balassa, B., "Subsidies and Countervailing Measures: Economic Considerations," *Journal of World Trade*, 23 J.W.T. 2, 73, 1989; Gaisford and McLachlan (1990); Hufbauer and Erb (1984) and Hufbauer (1990).

international trade. There is fairly broad consensus on the desirability of distinguishing between generally available and thus non-actionable subsidies and subsidies targetted for particular types of enterprises and hence more likely to be discriminatory and economically difficult to justify. One of the problems in implementing such a distinction, however, is that even subsidies that are advertised as generally available, may in practice be restricted to particular targetted firms or industries.

In cases of subsidies designed to offset existing distortions, Hufbauer and Erb have proposed that countries' market shares of the products affected be used to replace the current distinction in the international subsidies code between industrial subsidies in developed and developing countries. This is an intriguing idea, which has not received the detailed analysis needed to evaluate its attractiveness.

Natural resource pricing, the use of regional development and structural adjustment programs, and policies to encourage high-tech industries represent applications of subsidy policies that have created conflicts among countries. Questions have arisen with respect to both their status as non-actionable subsidies and the function of international oversight. In addition to the institutional problems involved in such oversight, procedural issues arise with respect to burden of proof, fact-finding, legal rulings, and dispute settlement.

A further source of disagreement pertains to the warranted size of a countervailing duty. When both parties to a dispute subsidize the same industry, the warranted countervailing duty is at best the difference between the two subsidies, in which case it may have to be negative if the subsidy in the countervailing country is higher. While the USA does tend to subsidize less than most countries, the patterns of subsidization vary considerably from one industry to another. Differences in points of view about the appropriate definition of industries and treatment of indirect subsidies can yield substantial variations in the calculations.

Furthermore, as Gaisford and McLachlan (1990) have shown, the answer becomes even more complicated in a world of multiple subsidies, multiple products, some of which may be inputs and/or non-tradable, and multiple factors of production. Under such circumstances, the notion, so dear to petitioners and policymakers alike, that a countervailing duty inevitably furthers the particular as well as the national interest quickly breaks down.

Alternative Strategies

As already noted, a serious shortcoming of U.S. policy is the frequent resort to VERs as the ultimate "resolution" of a CVD dispute. While avoidance of VERs and of negotiated price floors runs the risk of increasing international conflicts over CVD policies, their economic costs justify efforts to reduce their use. Outright prohibition of such measures may be too extreme, especially if political feasibility is considered. But sharp curtailment of their use is not difficult to justify.

Although such a policy revision could be directly implemented at the executive level of the U.S. government, some type of legislative action would doubtless be both desirable and required.[17] What form such action should take and whether it could be sold to Congress are questions that deserve careful attention. Part of the answer surely rests in ensuring more complete understanding of the full implications of CVDs. In addition to the issues raised above, policymakers and the public would have to be made aware of the fact that in a resource-constrained world a foreign subsidy which draws resources into one industry is more than likely pulling them out of another, so that a subsidy-induced increase in the other country's exports also increases its imports.

Similarly, a CVD which helps to increase employment and capital accumulation in one industry more than likely reduces both in one or more others. The strongly entrenched tendency to treat each countervailable duty as if it were the only intervention and entirely disconnected from all other policies is likely, upon examination, to be the source of a great many policy errors.

The propensity to settle CVD issues by means of VERs is an example of policy myopia from the standpoint of national efficiency concerns.[18] Given the tendency for VERs to reduce foreign opposition to domestic trade policy actions, it would be desirable to couple curtailment of the use of

17 There is a precedent for such legislation in Section 604 of the Trade and Tariff Act of 1984 which requires that for termination of a CVD investigation because of agreements with foreign governments to limit the exports in question, the Commerce Department must conclude that the agreement is in the public interest, taking into account specified factors which include whether the agreement would have a larger negative impact on U.S. consumers than the imposition of CVDs. See Bello, Judith Hippler, and Alan F. Holmer, *The Antidumping and Countervailing Duty Laws: Legal and Policy Issues*, Washington, DC: American Bar Association, 1987, pp. 114-15.

18 The origin of such policies may, of course, lie as much or more in catering to special interests as in actual myopia on the part of government officials.

VERs with reduction in the U.S. propensity to undertake CVD actions. One step in this direction, which has been proposed by several economists (including Balassa, 1989; Gaisford and McLachlan, 1990 and Wonnacott, 1985) is to increase the *de minimis* rate of foreign subsidization needed to trigger a U.S. policy response from the current 0.5% to, say, 1.0%. This proposal is based on the presumption that material injury would be unlikely to follow from subsidies below this rate. While the 1.0% level (to say nothing of the 0.5% level) is arbitrary, it would limit the number of CVD cases to some extent, provided that subsidizing nations do not respond by increasing the size of their subsidies.

Perhaps the potentially most important improvement would be to change the current injury provisions from a gross to a net definition. This would reflect the spirit of Finger's (1987) proposal that the injury determination process should involve not only domestic producers of goods which compete with subsidized imports, but the consumers of those goods. This change would recognize the existence of other legitimate interests. Just as domestic import-competing firms can suffer injury from foreign subsidization, domestic consumers suffer injuries from CVD and VER policies. Accounting for consumer interests in the injury determination process, that is, evaluating injury on an economy-wide basis, would substantially reduce the number of cases yielding a positive determination of injury.

Careful attention should be given to possible ways of implementing this suggestion. For example, the ITC, USTR, or the Council of Economic Advisers could be assigned the task of preparing estimates of costs to the economy which would accompany the imposition of particular CVDs. The adoption of a true test of net injury might well not prove to be politically saleable, but almost any movement in the direction of accounting properly for the costs of CVD actions for the rest of the economy would be helpful.

One advantage of this approach is that it would focus attention on strategic trade policy situations in which foreign subsidies are harmful to the overall economic interests of a country. Most typically, these would be situations involving the subsidization of high tech industries. As Hufbauer and Erb (1984, pp. 119-20) note, in such cases simply offsetting the foreign subsidy with a CVD would in all likelihood be insufficient to remove the competitive advantage which had been secured by foreign producers.

In such circumstances, direct negotiation with the foreign government, buttressed by the possibility of a countervailing domestic action, seems likely to be the best strategy. The greater the degree of international agreement which can be secured on rules of the game with respect to subsidies for strategic industries, the less conflictual will be relations in this

area. While efforts to resolve these disagreements must continue at the level of the GATT, it is also highly desirable to pursue the issue at regional levels, including the North American. Greater use of formal dispute settlement procedures is also desirable in cases where negotiated agreements cannot be reached. Indeed, a strong emphasis on such dispute settlement mechanisms would be one method of introducing a net injury test into policy practice.

As a potential model for more comprehensive agreements, the treatment of these issues within the context of a North American free trade agreement would seem to have a substantial advantage over the bilateral negotiations between the United States and Canada. The tripartite discussions would bring to the table countries at different stages of development, while still benefitting from the small number of negotiating parties and the other intangible attributes which make regional arrangements so popular. An important issue between developed and developing countries concerns the extent to which infant and strategic industry subsidies adopted by developing countries require international surveillance and control.

Countervailing Subsidies in Place of Duties

Hufbauer and Erb (1984) have suggested countervailing subsidies as an alternative to countervailing duties in order to account properly for the *consumer benefits* inherent in foreign subsidies. Replacement of a duty with a subsidy retains the output effect of the former, without impairing the consumer benefits inherent in subsidized imports. In this way, consumers continue to enjoy the benefits of lower prices, while domestic producers are protected from output and employment losses.

The countervailing subsidy does, however, entail an outlay on the part of the importing country's government. It still leaves incentives for foreign and domestic firms to reach market-restricting negotiated settlements prior to final determination of injury and hence of the countervailing subsidy. Indeed, importing country governments may have greater incentives to encourage negotiated settlements in order to avoid the outlays associated with countervailing subsidies.

In order to minimize budget costs to the importing country, Hufbauer and Erb suggest that countervailing subsidies be financed by low rates of duty on all imports originating in the subsidizing country. By imposing costs on many foreign export industries, this approach has the additional advantage of generating incentives against the use of targetted subsidies.

A potentially serious problem, however, is that there could develop considerable mismatches between the levels of foreign and domestic

subsidies. To match a given per unit foreign subsidy, as implied by the philosophy of our current CVD laws, but shown to lead to erroneous forms of intervention in many cases, relatively little revenue would be required for a small domestic industry, while considerable revenues might be required if the domestic industry were large. Especially in the latter case, it seems questionable whether the subsidy approach would promote overall economic efficiency. Further technical analysis is required to determine the conditions under which countervailing subsidies would be preferable to countervailing duties. While the CVS proposal is intriguing, it seems at best a second-best solution to the subsidy-CVD problem.

Rebating CVD Revenues

Gaisford and McLachlan (1990) have recently offered a proposal just the reverse of Hufbauer and Erb's. Their proposal calls for a rebate of CVD tariff revenue to the subsidizing nation. It is based on the notion that the revenue gained through the imposition of CVDs comes as a windfall to the countervailing nation and represents an unwarranted incentive encouraging the use of CVDs.

A rebate of this type may be viewed as a side payment, and as such might have two unfortunate consequences. First, the original subsidizing nation obtains additional revenues with which to break fiscal constraints on subsidization. Since, as Hufbauer notes (1990, p. 94), this fiscal constraint has become increasingly binding of late, the proposal to rebate CVD revenues might encourage greater use of subsidies. Second, eliminating the incentive on the part of the responding nation to apply CVDs without reducing the ease with which actions can be brought would encourage the use of cartelized export restraints as an alternative to CVDs.

If we interpret subsidized imports as creating an externality, then it is possible to apply the Coase theorem (1960) to the subsidy-CVD issue.[19] The Coase theorem suggests that if property rights are well established, with respect to the right of a sovereign state to subsidize or countervail, then externalities can be internalized in an economically efficient manner through the use of appropriate side payments. For example, if the USA finds evidence of injury from a Mexican subsidy, one policy solution would be for the U.S. government to make a *side payment* to the Mexican Government--the real creator of the externality as opposed to the exporting firm--to abandon the subsidy policy.

19 Coase, R., "The Problem of Social Cost," *Journal of Law and Economics*, 1960.

At some point, the benefits to Mexico from subsidization would be less than the side payment from the USA and a change in policy would be effected. Alternatively, if a countervailing duty is settled upon as an appropriate policy in the USA, but that CVD causes some *external harm* to Mexico, then Mexico might make a side payment to the injured firm in the USA if it wishes to maintain its export subsidy.

Coasian side payments between states would eliminate the firm-to-firm negotiations that currently bring about much of the harm generated by the subsidy-CVD process. Since the subsidizing country government, not the subsidized firm, *is responsible for the externality*, it is best to focus on a change of country policy, not firm behaviour.

Third-Country Effects and Complications in the Coasian Approach

In many subsidy cases, there are more parties involved than just the exporting and importing countries. Other countries which export to the same market might see their interests affected. For instance, suppose both Canada and Mexico export some good to the U.S. Canadian production subsidies on exports to the USA not only affect competing American firms, but Mexican exporters to the USA. A system of state-to-state side payments could address the claims of all injured parties. Although an increase in the number of parties involved increases the difficulty of reaching an efficient Coasian solution, this may still be an attractive way of handling major third country effects since current CVD policies are poorly suited to deal with such issues.[20]

Although the Coasian approach to these issues offers some interesting possibilities, some important political economy considerations may hinder its practical applicability. Given the conflicting views about the objective of policy with respect to subsidy-CVD issues, it could be quite difficult to secure agreement on an initial assignment of "property rights" with respect to the rights to subsidize and the rights to engage in CVD activities. In the absence of a clear assignment of property rights, Coasian bargaining will not always lead to agreement.

Furthermore, with the explicit or implicit establishment of the wrong set of property rights, the ability of special interests to collude could be enhanced. Thus, in VER negotiations, for example, the implicit recognition of the property rights of foreign firms to export to the USA and of U.S. firms' rights to be protected from foreign competition has combined to

20 See, for example, Hufbauer and Erb (1984, pp. 117-18).

undermine consumers' rights to free imports and has resulted in the adoption of particularly damaging cartelizing measures. While the resulting aggregate costs to consumers far exceed the gains generated for domestic and foreign producers, the large number of consumers presents traditional collective action problems which prevents their bribing producers to give up their restrictive practices. In such large-number cases, where transactions costs are significant, the simple Coase theorem that economic efficiency is not influenced by the distribution of property rights does not hold. Thus recognition of the possibilities of Coasian bargaining doesn't relieve us of the necessity to clearly define rights to trade (and to limit trade).[21]

Conclusions

The intractability of the subsidy-CVD issue is in part a conceptual and analytical matter and in part one of policy and practice. The conceptual problem is to identify harmful and distorting subsidies and to select from those subsidies that are harmful to the interests of other countries. A related and no less important matter is to evaluate the costs and effectiveness of alternative antidotes.

The practical problem is to devise criteria and rules for international intervention in the case of subsidies that warrant such intervention on grounds of principle. Guidelines and procedures are needed for subsidies that warrant international concern. Among the key requirements here is the formulation of guidelines not only for countries wishing to subsidize, but for those resorting to countervailing policies. Legal and institutional mechanisms are needed for international surveillance, enforcement, and dispute settlement.

National governments have at present too much discretion in the use of both subsidies and countervailing measures. Although the GATT has something to say about both (in Articles VI and XVI and in various Tracks of the Subsidies Code), see Jackson (1990) for details. The guidelines are ambiguous and weak and not supported by adequate compliance and dispute settlement procedures.

21 Attention also needs to be given to the proper form of side payments, since implementation of such payments has proven to be particularly difficult in international regulations. On the use of issue linkages as a substitute for side payments in international negotiations, see Tollison, R., and Thomas D. Willett, "An Economic Theory of Mutually Advantageous Issue Linkages in International Negotiations," *International Organization*, Autumn, 1979.

U.S. policy on countervailing duties is confused and muddled. Policymakers rarely know the full implications of foreign subsidies for U.S. interests and when they know, existing law prevents them from acting intelligently on that information. U.S. producers of import-competing goods have been allowed to view CVDs as entitlements; they have utilized that privilege to collude with foreigners in introducing monopolistic distortions into many markets.

On political economy grounds, the trend to circumvent formal procedures through the negotiation of voluntary restraints is quite understandable. By facilitating monopolistic restrictions, protection of domestic producers is kept from harming influential foreign producers. As a result, dangers of retaliation are substantially reduced and strains on international relations are lessened. But such "cooperative protectionism" is imposing heavy costs on consumers and the overall efficiency of the economy. Efforts to put a halt to such negotiated market cartelizations need not wait for resolution of the full range of analytical complexities in the delineation of optimal CVD policies.

Improvements in CVD policies, however, are unlikely to be forthcoming without greater agreement on the role of subsidies. The difficulty of that undertaking is amply illustrated by the failure of the USA and Canada to reach agreement on a subsidies code, and this in spite of the predominance between the two countries of similar traditions and perspectives on the issue. All the same, Canada could not overcome the constraint inherent in the greater policy role of subsidies at both the federal and provincial levels. The differences in the weights attached to subsidy use in national economic strategies in the case of the USA and Mexico are, of course, several times greater and hence may be even harder to reconcile.

There is, moreover, a legitimate question regarding the suitability of bilateral or regional arrangements for the resolution of disagreements over subsidies. An important advantage favouring bilaterals would seem to rest in the small number of players relative to multilateral forums within the GATT. On the other hand, a deal with a single trading partner is unattractive because it limits the reciprocal benefits a country obtains for reducing its subsidies in comparison with the gains implicit in a reciprocal arrangement involving many countries. The relative weights of these considerations would vary among industries and would depend on the importance to Canada and Mexico of competition with other subsidizing countries and on the magnitude of foreign industrial subsidies.

Given that subsidies are more extensive in Canada (and even more so in Mexico) than in the United States, many Canadians believed not only that they would gain relatively little from bilateral resolution of this issue, but

also that any reduction in domestic subsidies would place Canadian producers at competitive disadvantages vis-à-vis third countries.

The political economy in this context is such that economists' claims that the inherently welfare-reducing impact of many subsidies implies that even unilateral--that is, unreciprocated--elimination of subsidies would be beneficial does not carry very far. Far more important in convincing Canadians of the value of a bilateral agreement would be the expectation of greater constraints on U.S. CVD policies.

In the end, however, the USA and Canada agreed merely to continue their talks on a new subsidies code for several more years and to establish in the meanwhile a bilateral panel for the review of administrative agency findings under the application of the respective national laws. Unable to agree on a new code, they provided for improved dispute settlement procedures pertaining to the application of national law.

The importance of bringing Mexico into these negotiations is clear, for any USA-Canada agreement on a new subsidies code would benefit Mexico. The need to extract reciprocal concessions from Mexico is viewed as especially important in light of Mexico's long history and relatively aggressive use of subsidies.[22]

Mexico has recently rewritten its subsidy code to conform more closely with U.S. law.[23] While this should facilitate regional negotiations of a new code, Mexico unlike Canada has little experience in the administration of codes of this type. Furthermore, subsidies embedded in Mexico's federal budget have drawn criticism, but similar charges can easily be addressed to the United States and Canada. Although parastatals and other enterprises targetted by state policies have traditionally been major recipients of domestic subsidies, Mexico has in the years since the inception of the current program of economic reforms substantially reduced the role of parastatals through privatization. Still, a key issue needing resolution concerns subsidies embedded in the pricing structures of the remaining parastatals, especially those in the energy sector, to ensure either the removal of such subsidies or their "general availability" to American and Canadian users. The complexity of the task is readily apparent, not least because limiting general availability to North American users may run afoul

22 On this issue, see Morici, P., *Trade Talks with Mexico: A Time for Realism*, Washington, DC: National Planning Association, 1991.

23 See U.S. International Trade Commission, *Review of Trade and Investment Liberalization Measures by Mexico and Prospects for Future United States-Mexican Relations*, Washington, DC: April 1990.

of the spirit if not the letter of the GATT's most-favoured-nation clause. If, on the other hand, general availability is applied to third countries, the competitive value of the agreement to the USA and Canada is correspondingly reduced.